for Sustainable Development Office (www.un.org/esa/ffd/tax-cooperation/practical-portfolios.html).[1]

4. The paper contained in the annex to the present note is a summary of the United Nations Practical Portfolio on Protecting the Tax Base of Developing Countries against Base Erosion: Income from Services, which is focused on the tax treatment of income from services under the domestic law and tax treaties of developing countries from the perspective of potential tax base erosion and profit shifting.

5. The Portfolio is intended to assist tax officials from developing countries in reviewing the provisions of their domestic law and tax treaties that deal with the taxation of income from services in order to identify the major risks of base erosion and the countermeasures that developing countries can take to reduce or eliminate those risks.

6. One of the major risks of base erosion is transfer pricing abuse with respect to cross-border payments for services between entities that are part of a multinational group. Transfer pricing is not dealt with extensively in the Practical Portfolios because the topic is covered in the United Nations Practical Manual on Transfer Pricing for Developing Countries. Instead, the Practical Portfolio on Income from Services contains a comprehensive identification of the risks of base erosion with respect to income from services and possible countermeasures thereto, in recognition of the widely varying experiences of developing countries, and to provide tax officials from those countries with as much information as possible. In the summary contained in the annex, however, only the most important risks of base erosion with respect to income from services are covered.

7. Neither the Portfolio nor the summary thereof in the annex deals with the domestic law or tax treaties of particular countries, but rather the basic patterns of taxation of income from services that are commonly found in the domestic law and tax treaties of developing countries. Tax officials from developing countries should adapt the materials to their particular situation.

8. The Portfolio comprises four parts: part 1 consists of a general introduction; part 2 includes an analysis of the provisions of the domestic law and tax treaties of developing countries dealing with the taxation of income from services, the risks of base erosion with respect to such income and possible countermeasures; part 3 contains guidance for tax officials from developing countries in designing and drafting domestic legislation and in negotiating tax treaties to counter base erosion and profit shifting; and part 4 includes guidance in the administrative aspects of the provisions of the domestic law and tax treaties of developing countries dealing with income from services.

9. The Portfolio is available only in English. The summary contained in the annex to the present paper is intended to provide access to the basic contents of the Portfolio in the other five official languages of the United Nations. It is not intended as a substitute for the much more comprehensive analysis of the risks of base erosion and possible countermeasures presented in the Portfolio. For more detailed information, readers are encouraged to consult the full text of the Portfolio.

[1] United Nations, Department of Economic and Social Affairs, Financing for Development Office, United Nations Practical Portfolio series, 2017; "Protecting the Tax Base of Developing Countries against Base Erosion: Income from Services"; "Protecting the Tax Base of Developing Countries against Base-eroding Payments: Interest and Other Financing Expenses"; and "Protecting the Tax Base of Developing Countries against Base-eroding Payments: Rent and Royalties".

Annex

Summary of the United Nations Practical Portfolio on Protecting the Tax Base of Developing Countries against Base Erosion: Income from Services*

I. Major risks of base erosion with respect to income from services under domestic law

Introduction

1. A country's tax base may be eroded with respect to income from services if: (a) the country does not tax certain income from services; (b) it allows a deduction for payments for services against its tax base, but does not tax those payments; or (c) the tax on the payments is less than the tax savings resulting from the deduction of the payments.

2. Although the word "services" is not generally defined either in domestic law or tax treaties, it should be given a broad meaning and include any activities performed by one person for another in consideration of a fee. Under domestic law and tax treaties, it is often necessary to distinguish between payments for services and royalties or rent for the use of certain property or equipment, as well as to distinguish between various types of services, including employment, professional and independent services, international shipping and air transportation services, entertainment and sports services and technical services.

Taxation of residents

3. For developing countries, the risks of base erosion are less serious with respect to income from services derived by its resident taxpayers than to such income derived by non-residents. Therefore, for the purpose of this summary, the risks of base erosion with respect to residents of a developing country and possible countermeasures thereto are dealt with only briefly. For more detailed information concerning the taxation of residents on income from services, readers should consult the Practical Portfolio on Protecting the Tax Base of Developing Countries against Base Erosion: Income from Services.

4. The major risk with respect to the taxation of residents on income from services arises if a developing country taxes on a so-called "territorial" basis, that is, in general, it taxes only income that is sourced in or derived from its territory; it does not tax income derived outside its territory, or foreign source income. The risk can be effectively eliminated if a country imposes tax on the worldwide income of its residents, so-called "worldwide" taxation.

5. Even if a country taxes its residents on their worldwide income from services, including income from foreign countries, there is a risk of base erosion if the country allows a credit for foreign tax on foreign source income and the credit is not limited to the amount of domestic tax on such income since otherwise the credit will, in effect, reduce domestic tax on domestic source income. It is also necessary for any expenses incurred by a resident in earning foreign source income to be allocated to such income for the purpose of computing the limitation on the foreign tax credit.

6. Whether a developing country exempts foreign source income from services or taxes that income with a credit for the foreign tax on the income, the rules for determining the geographical source of the income are very important. If income from

* Prepared by Brian J. Arnold, Senior Adviser, Canadian Tax Foundation.

services is considered to be domestic source income, it should not be exempt from domestic tax under a territorial or exemption system. Furthermore, under a worldwide system, no foreign tax credit should be allowed on any income from services that is considered to be derived from domestic sources. Typically, income from services is considered to be derived from the country in which the services are performed by individuals who are present in that country; however, several developing countries also consider income from services to be earned where the services are used or consumed in the country.

7. Residents of a developing country that taxes on a worldwide basis may avoid such taxation by establishing a controlled foreign corporation to earn income from services performed outside the country. Because a controlled foreign corporation is usually a separate taxable entity and not resident in the country in which the controlling shareholder is resident, the income earned by the corporation will not be taxable by that country. Developing countries can deal with this risk by enacting rules relating to controlled foreign corporations under which the resident shareholders of the corporation are taxable on the income derived by the corporation even if that income is not distributed to them.

Taxation of non-residents

8. The risks of base erosion with respect to income from services derived by non-residents depend on whether a country taxes non-resident service providers only on income from services performed in the country or whether it also taxes non-residents on income from services that are used or consumed by residents of the country.

9. In the first case, income from services performed in a country may be taxed on a net basis if a minimum threshold requirement is met, such as a permanent establishment or presence in the country for a minimum period. Other income derived by non-residents from services may be exempt from domestic tax, such as income from employment exercised outside the country, or taxable on a gross basis through a withholding tax.

10. In the second case, income derived by non-residents from services consumed or used in a country is sometimes taxable by that country through a gross-basis withholding tax. This type of tax on services used or consumed by resident individuals is difficult to collect. Therefore, some countries impose tax on payments for services performed outside the country only if the payments to the non-resident service provider are deductible by residents of that country or by non-residents with a permanent establishment in that country who are subject to net-basis taxation by that country. This type of withholding tax is often used by developing countries with respect to payments for consulting, technical or managerial services. For example, Company R, a resident of Country R, provides management services to its wholly owned subsidiary, Company S, resident in Country S. The services are performed by officers and employees of Company R who work exclusively in Country R. In this situation, Company S is likely to deduct the payments to Company R for the management services in computing its income subject to tax in Country S. As a result, Country S may impose a withholding tax on those payments, notwithstanding the fact that the services are performed outside Country S.

II. Major risks of base erosion with respect to income from services under tax treaties

Introduction

11. The provisions of tax treaties may sometimes create opportunities for base erosion with respect to income from services because tax treaties often limit the taxes imposed by one contracting State on residents of the other contracting State. For any developing country, the extent to which its bilateral tax treaties allow its domestic tax base to be eroded depends on: (a) how many tax treaties it has concluded; (b) the countries with which it has concluded tax treaties; and (c) the provisions of those tax treaties.

12. In general, tax treaties are based on the United Nations Model Double Taxation Convention between Developed and Developing Countries or the Model Tax Convention on Income and on Capital of the Organization for Economic Cooperation and Development (OECD). Many developing countries negotiate the provisions of their tax treaties on the basis of the United Nations Model Convention because it provides greater taxing rights for source countries.

13. In general, tax is not imposed under the provisions of tax treaties, but under a country's domestic law. Therefore, if an amount of income derived by a non-resident from a country is not taxable under that country's domestic law, the question of whether the country has the right to tax the amount under the provisions of an applicable tax treaty is irrelevant.

14. The provisions of the United Nations and the OECD Model Conventions include rules dealing with the following types of income from services:

(a) Income from employment, as follows:

(i) General rules under article 15;

(ii) Directors' fees and remuneration of top-level managers under article 16;

(iii) Pensions under article 18;

(iv) Government service under article 19;

(b) Income from entertainment and sports activities under article 17;

(c) Income from professional and other independent services under article 14 of the United Nations Model Convention;

(d) Income from other business services under articles 5 and 7, as follows:

(i) Construction under article 5 (3) (a) of the United Nations Model Convention and article 5 (3) of the OECD Model Convention;

(ii) Services furnished by an enterprise under article 5 (3) (b) of the United Nations Model Convention;

(iii) Insurance under article 5 (6) of the United Nations Model Convention.

15. Each of the above-mentioned articles is covered briefly below with respect to the risk of base erosion that they present; however, more emphasis is given to income from business services since they are more prevalent and involve larger amounts of income and greater risk of base erosion.

16. Although tax treaties based on the United Nations and the OECD Model Conventions do not generally limit a country's authority to tax its own residents, pursuant to articles 8 (International shipping and air transport), 18 (Pensions and social security payments) and 19 (Government service), a contracting State's ability

to tax its residents is restricted. Nevertheless, these provisions do not involve serious risks of base erosion and are not discussed further in this summary.

Income from employment

17. Under the provisions of article 15 of the United Nations and the OECD Model Conventions, a country in which employment services are exercised is prevented from taxing the income from such services unless the employee is: (a) employed by a resident of that country; (b) employed by a non-resident with a permanent establishment (or a fixed base under the United Nations Model Convention only) in that country and the employment income is deductible in computing the profits attributable to the permanent establishment or the fixed base; or (c) present in that country for more than 183 days in any 12-month period beginning or ending in the relevant fiscal period.

18. The most serious risks of base erosion with respect to income from employment include:

(a) A non-resident employer artificially avoids establishing a permanent establishment or fixed base in a developing country so that the services of non-resident employees of that employer who perform employment services in that country are not taxable there unless the employees are present in the country for more than 183 days in any 12-month period;

(b) The relationship between the payer, or employer, and the service provider, or employee, is structured as an independent contractor relationship, although in substance the relationship is one of employment: if taxpayers are independent contractors, they are subject to tax by the country in which the services are rendered only if they do business through a permanent establishment or a fixed base in that country;

(c) To avoid non-resident employees being employed by an employer resident in a developing country, the employees may be nominally employed by a non-resident agency that hires them out to clients in the developing country, the so-called practice of international hiring out of labour;

(d) Article 15 is limited to income from employment services exercised in a country; as a result, base erosion will occur where a resident employer makes deductible payments of salary to a non-resident employee who performs the duties of employment outside the country.

Income from entertainment and sports activities under article 17

19. Some entertainers and sportspersons can make large sums of money in a short period of time. They may be self-employed, employees of an entity such as a team or an orchestra or employees of an entity that they control or own. Under article 17 of the United Nations and the OECD Model Conventions, a contracting State in which a resident of the other State performs entertainment or sports activities is entitled to tax the income derived from such activities without any limitations. Thus, most countries impose withholding tax on the gross amount earned by entertainers and sportspersons resident in the contracting State. Under article 17 (2), the country in which entertainment or sports activities are performed is also entitled to impose tax on any income from those activities that is assigned by the entertainer or sportsperson to a related person, such as a controlled company, a spouse or children.

20. The major risk of base erosion with respect to income from entertainment and sports activities can be attributed to the fact that developing countries may not have the necessary provisions in their domestic law to impose tax on such income.

Income from professional and other independent services under article 14

21. Under article 14 of the United Nations Model Convention, a contracting State is prevented from taxing income in respect of professional services and other activities of an independent character performed in that State by a resident of the other contracting State unless the service provider has a fixed base regularly available in the first State or spends at least 183 days in any 12-month period in the first State. To the extent that amounts paid to non-resident professionals or other independent service providers are deductible against a developing country's tax base, that country's tax base will be eroded and the base erosion will not be offset by tax on the non-resident service provider.

22. The major risks of base erosion with respect to article 14 are as follows:

(a) Professionals and other independent service providers resident in countries with which a developing country has tax treaties may earn substantial amounts of income from the developing country without the need for a fixed base in that country or the need to spend 183 days there. As a result, the developing country cannot tax the income even if the payments to the service providers are deductible against the developing country's tax base;

(b) Professionals and other independent service providers resident in countries with which a developing country has tax treaties may earn income from services performed for residents of that country, but provided outside that country. As a result, the payments to the non-resident service providers are deductible against the developing country's tax base but, under article 14, the country is prevented from taxing the income derived by the non-resident service provider.

Income from other business services under articles 5 and 7

23. Under article 7 of the United Nations and the OECD Model Conventions, a service provider resident in one contracting State is subject to tax on business profits derived from the other contracting State only if the service provider carries out business in the other State through a permanent establishment located in that State and only to the extent that the profits are attributable to the permanent establishment. A permanent establishment is defined in article 5 as a fixed place of business through which the business of an enterprise is carried on unless that place is limited to carrying on preparatory or auxiliary activities. In addition, a dependent agent who acts in a contracting State on behalf of a person resident in the other contracting State is deemed to be a permanent establishment with respect to such a person if the agent has and habitually exercises the authority to conclude contracts binding on that person or plays the principal role leading to the conclusion of contracts that are routinely approved by that person.

24. The following special rules apply to construction, the furnishing of services by an enterprise and insurance:

(a) Under article 5 (3) (a) of the United Nations Model Convention, a building or construction site or an installation project constitutes a permanent establishment only if the activities last for at least 6 months (12 months under the OECD Model Convention);

(b) The furnishing of services by an enterprise in a country is deemed to be a permanent establishment if the services are performed by its employees, or other personnel engaged by the enterprise for such a purpose, for at least 183 days in any 12-month period (before the updated 2017 to the United Nations Model Convention, under its article 5 (3) (b), the services were also required to be performed for the same or a connected project);

(c) Under article 5 (6) of the United Nations Model Convention, the insurance of risks located in a country or the collection of premiums in a country is deemed to be a permanent establishment.

25. The provisions of articles 5 and 7 of the United Nations and the OECD Model Conventions present several serious risks of base erosion with respect to income from business services. In general, the definition of a permanent establishment provided in article 5 represents a high threshold for the taxation of income from business services. In many circumstances, taxpayers, in particular multinational enterprises, resident in countries with which a developing country has concluded tax treaties can earn substantial amounts of revenue in the developing country without needing to establish a permanent establishment in that country.

26. In some situations, taxpayers may use various tax avoidance strategies to avoid having a permanent establishment in a developing country. For example, some taxpayers may be able to:

(a) Shift the location of their business activities from place to place within a country so that the activities do not take place in one location for more than 183 days;

(b) Provide services for different or unconnected projects within a developing country for more than 183 days;

(c) Limit construction activities within a developing country to a duration of less than 6 months, or 12 months if the treaty includes the time threshold proposed in the OECD Model Convention is applied.

(d) Split activities, such as construction, in a developing country among related entities so that no one entity has a permanent establishment, although if the activities are aggregated, there would be a permanent establishment in the country;

(e) Provide services, such as digital services, outside a developing country for clients in the developing country so that payments for the services are deductible against the developing country's tax base but, under the provisions of a treaty, the developing country is prevented from imposing tax on the non-resident service provider with respect to those payments;

(f) Pay an amount for the services that is greater or less than their fair market value, that is, the amount that would be paid for the services by persons dealing at arm's length with one another, if a non-resident service provider and a client resident in a developing country are related or are not dealing at arm's length;

(g) Carry out substantial insurance activities in a developing country without establishing a permanent establishment in the country, unless the tax treaties of the developing country include provisions similar to article 5 (6) of the United Nations Model Convention.

III. Countermeasures to prevent base erosion with respect to income from services

Introduction

27. Each developing country must decide for itself whether and to what extent it is concerned about the risks of base erosion with respect to income from services and, if so, how to best deal with those risks. Identified in the present section are possible countermeasures that developing countries might adopt to deal with the major risks of base erosion resulting from the provisions of a developing country's domestic law or from its tax treaties with respect to income from services. The information is intended as guidance, not a recommendation, for developing countries to take into

account when considering whether to adopt countermeasures to prevent base erosion and the application of those measures.

Countermeasures under domestic law

28. Developing countries normally tax some non-resident service providers on a net basis and some on a gross withholding tax basis. In general, non-residents are taxable on a net basis only if they have a substantial presence in a country, which facilitates gathering the necessary information and collecting the tax. Taxing non-residents on a net basis imposes significant compliance costs on the non-residents and the tax authorities: tax returns must be filed and assessed, and tax must be collected. To ensure collection of the tax, some countries impose an obligation on residents to withhold tax on payments for services made to non-residents, even if the non-residents are taxable on a net basis; they may also require non-residents who are taxable on a net basis to pay tax instalments periodically.

29. Where non-resident service providers are taxable on a net basis under a developing country's domestic law only if they have a substantial presence in the country, such as a permanent establishment or a physical presence for a substantial period of time, they may use various tax avoidance strategies to avoid having the substantial presence. To counter or minimize the risks of base erosion, a developing country might consider the following options:

(a) Not having a substantial presence threshold in its domestic law for taxing non-resident service providers, although such a rule may be difficult to enforce and may discourage non-residents from performing services in the country;

(b) Designing a threshold requirement that is difficult to avoid and supplementing it with anti-avoidance measures: for example, services provided by non-residents in different places in a developing country and by related or associated enterprises could be aggregated for the purposes of determining whether any threshold is met; similarly, multiple contracts entered into with the same client could be aggregated and any presence test could be based on a non-resident's aggregate presence over a longer period of time rather than on a continuous period of presence.

30. These considerations apply equally to construction services and professional and other independent personal services. Developing countries should carefully consider the relationship between any domestic thresholds for the taxation of non-resident service providers and the threshold requirements in their tax treaties, as discussed in paras. 39 to 47 below.

31. With respect to non-resident insurance companies doing business in a developing country, the country might consider taxing the companies if they perform certain activities, such as collecting premiums or insuring risks in the country, and then ensuring that they include article 5 (6) of the United Nations Model Convention in their tax treaties to protect the imposition of domestic tax on non-resident insurance companies. Otherwise, the insurance companies may be able to derive substantial amounts of income from a country without paying any tax on the income. Moreover, to the extent that the insurance premiums are deductible against the developing country's tax base, there will be further base erosion.

32. If a non-resident service provider does not have a substantial presence in a developing country, the only feasible method by which the country can impose tax on the non-resident is through a withholding tax on the gross service fees. The persons paying for the services — residents and non-residents doing business in the country through a permanent establishment or a fixed base — are required to withhold an amount from the payment as tax or in account for the final tax payable and remit that amount to the tax authorities. A developing country might also consider denying any

deduction for payments to non-residents in consideration for services; however, in most cases, the payments will represent legitimate expenses that should be deducted. An alternative way to prevent base erosion would be to make withholding a condition for the deduction of the payments. Thus, no deduction for payments to non-residents for services would be allowed unless the payer were to withhold tax from the payments, so that the withholding tax would offset the erosion of the tax base from the deduction.

33. The rate of withholding tax imposed by developing countries on payments to non-residents for services is an important issue. In principle, the rate should be a proxy for a tax on the net income derived by the service provider. If the rate is excessive, it may discourage non-residents from providing services to residents of developing countries or force them to pass the tax on to their clients in those countries, making the cost of such services higher. If different rates of withholding tax are imposed on different types of services, the compliance burden on withholding agents will be increased; therefore, if possible, the same rate of withholding tax should be applied to all payments for services. Typically, however, many developed and developing countries impose withholding taxes only on payments to non-resident entertainers and sportspersons and on remuneration paid to non-resident employees, including directors and officers of resident companies; they do not impose withholding tax on payments for services to non-residents who have a substantial presence, such as a permanent establishment, in the country and are taxable on a net basis. Several developing countries also impose withholding taxes on payments to non-residents for technical services.

34. A developing country must decide whether withholding taxes on payments to non-residents for services will be limited to services performed in the country or extend to payments for services performed outside the country but consumed or used inside the country. This issue often arises with respect to fees for consulting, technical and management services. For example, a multinational company may establish a group company in a low-tax country to provide consulting, technical or management services to another group company in a developing country. Some or all of these services may be performed outside the developing country; however, the payments for the services may be deductible under that country's domestic law, irrespective of where they are performed. Furthermore, as discussed below, under the article on non-discrimination of the United Nations and the OECD Model Conventions, payments to residents of a treaty partner must be deductible on the same terms as they would be if the payments were made to residents of the developing country. The deduction of the payments for services against the developing country's tax base provides a justification to impose withholding tax on the payments, even if the services are performed outside the developing country.

35. Payments for services by residents of a developing country to related non-resident persons, in particular non-resident persons resident in low-tax countries, pose special risks of base erosion. Most countries have transfer pricing rules to prevent residents from making deductible payments to related non-residents for services in excess of the fair market value or arm's length price of the services. Transfer pricing rules are very difficult for developing countries to apply effectively, however. Therefore, developing countries could consider imposing withholding taxes on common types of intragroup services, such as consulting, technical and management services, as well as protecting the application of the withholding taxes in their tax treaties by including article 12A of the 2017 United Nations Model Convention in all their treaties, as discussed below.

36. Typically, an obligation to withhold payments to non-residents for services is imposed on resident businesses and non-residents with a permanent establishment or fixed base in a country. These payers will generally claim a deduction for the

payments and, as a result, the withholding tax is necessary to offset the erosion of the tax base caused by the deduction. An obligation to withhold is not generally imposed on individual consumers resident in a country who pay amounts to non-residents for services, because the consumers are not usually entitled to deduct the payments and it is difficult to enforce an obligation to withhold against individuals. Failure to withhold should be subject to interest and penalties, and many countries impose joint liability on the withholding agent for the amount of the tax. In addition, the deductibility of payments to non-residents for services can be made conditional on the payer withholding the appropriate amount of tax from the payment.

37. The following types of payments to non-residents for services are often subject to withholding tax:

(a) Salary, wages and other remuneration, including pensions, paid to non-resident employees by resident employers, non-resident employers with a permanent establishment or fixed base in the country or the Government;

(b) Directors' fees and remuneration of top-level managers paid by companies resident in a developing country;

(c) Amounts paid to non-resident entertainers or sportspersons for services performed in a developing country by the promoter of the event or the owner of the venue;

(d) Deductible payments for international shipping or air transportation services;

(e) Amounts paid to non-residents for consulting, technical or management services.

38. Although withholding taxes are typically applied to actual payments to non-resident service providers, there are circumstances in which it is necessary for withholding taxes to be applied to deemed payments, such as deemed amounts paid pursuant to transfer pricing rules and deemed payments on the accrual of deductible expenses.

Countermeasures under tax treaties

39. Some provisions of the United Nations and the OECD Model Conventions limit the taxation measures of domestic law. If possible, developing countries should avoid including these measures in their tax treaties or modify them so that the treaties will not prevent the application of countermeasures against base erosion in domestic law. Through other provisions of the Model Conventions, developing countries are granted taxing rights with respect to income from services and taxpayers are prevented from engaging in tax avoidance strategies in order to obtain treaty benefits inappropriately. If possible, developing countries should ensure that these provisions are included in their tax treaties.

40. Developing countries may consider modifying or not including the provisions contained in the following articles of the United Nations and the OECD Model Conventions in their tax treaties:

(a) Article 14: it might be possible for a developing country to negotiate a shorter time period — 90 or 120 days, rather than 183 days — for a non-resident performing professional or other independent services in the country to be subject to tax on the income from such services;

(b) Articles 5 and 7: it might be possible for a developing country to negotiate a shorter time period than the existing 183-day period for recognition of a services-related permanent establishment under article 5 (3) (b) of the United Nations Model

Convention and to delete the "same or connected project" requirement that was previously included in article 5 (3) (b). Developing countries could also consider adopting a time period for construction projects that is shorter than the six-month period included in article 5 (3) (a) and negotiating a special provision that would allow construction projects at different sites within the country to be aggregated;

(c) Article 24 (3): through the provision in this article, a country is prevented from discriminating against a non-resident employer with a permanent establishment in the country relative to a resident employer in the same circumstances. Most countries will insist on the inclusion of this provision in their treaties. The provision does not present any difficulties for developing countries so long as they require resident employers to withhold tax from the salary and wages of non-resident employees and do not deny non-resident employers the right to claim a deduction for the salary and wages paid to non-resident employees in computing the profits attributable to the permanent establishment;

(d) Article 24 (4): if a developing country wishes to deny the deduction of payments to residents of its treaty partners for certain services, it must avoid including article 24 (4) in its treaties or modify that provision to exclude payments to non-residents for those services.

41. Developing countries should consider including the following articles of the United Nations Model Convention in their tax treaties:

(a) Article 15, which includes a special provision to prevent the international hiring out of labour (see para. 1 of the commentary on article 15 of the United Nations Model Convention);

(b) Article 16, to require resident companies paying directors' fees and the remuneration of top-level managers to withhold tax on such payments in accordance with the developing country's domestic law;

(c) Article 19, to permit the Government of a developing country to tax remuneration paid by it to non-resident employees;

(d) Article 18 B, to allow a developing country to tax pensions paid to non-resident employees;

(e) Article 17, including its paragraph 2, to allow a developing country to tax all income from entertainment or sports activities performed in the country, including any such income assigned to another person;

(f) Article 5, including the anti-avoidance rules added in 2017, to prevent the artificial avoidance of permanent establishment status;

(g) Article 5 (6), to allow a developing country to tax income from the collection of insurance premiums or the insurance of risks in the country;

(h) Article 29 (9), which comprises the general anti-abuse rule added in 2017, to allow a developing country to deny treaty benefits in abusive situations.

42. As noted above, multinational corporations can erode a developing country's tax base by using a group company established in a low-tax jurisdiction to provide various types of services — consulting, technical or management services — to another group company doing business in the developing country. The fees for services paid by the group company in the developing country are typically deductible against the country's corporate tax base. Although the developing country may impose withholding on the fees under its domestic law, the provisions of a tax treaty between the developing country and the country in which the service provider is resident may prevent the imposition of any withholding tax on the fees.

43. To deal with this risk of base erosion, developing countries can avoid concluding any tax treaties, in particular with low-tax countries, which is a drastic response with possibly disadvantageous consequences, or insist on the inclusion of provisions in their tax treaties that allow them to impose withholding tax at a reasonable rate on deductible payments for services. For many developing countries, entering into tax treaties is an important means of attracting foreign investment. Therefore, it is important for them to include provisions in their tax treaties, such as article 12A of the 2017 United Nations Model Convention, that allow them to impose withholding tax on payments for services.

44. Under article 12A, a contracting State may impose tax on fees for technical services "arising" in that State and paid to a resident of the other contracting State at a rate agreed by the two States. Fees for technical services are deemed to arise in a State in which the payer is a resident, or a non-resident with a permanent establishment or fixed base in that State, and the fees are deductible in computing the profits attributable to the permanent establishment or fixed base. If, however, the non-resident service provider has a permanent establishment or fixed base in the contracting State in which the fees for technical services arise, the fees are taxable on a net basis, in accordance with article 7 of the United Nations Model Convention.

45. Fees for technical services are defined as payments for consultancy, technical and management services, except for the following payments: (a) to employees, because, as explained above, the risks of base erosion are small — non-resident employees performing services in a country for an employer resident in that country or a non-resident with a permanent establishment in that country are taxable by that country under article 15; (b) for teaching in or by an educational institution, which is excluded because such activities are considered to be desirable and the risks of base erosion are small; and (c) for services for the personal use of any individual, because such payments are not deductible by the payer and the risks of base erosion are small.

46. Although the words "consultancy", "technical" and "management" are not defined and, therefore, have their ordinary meanings they are not intended to have the meanings that they have under the domestic law of the country applying the treaty. As explained in the commentary on article 12A, technical services include services that require specialized knowledge, skill or expertise and do not include routine standardized services. Furthermore, technical services include only specialized services that are performed for the benefit of a client; they do not include specialized services that are performed by an enterprise for itself. Thus, for example, if an enterprise uses specialized services to develop standardized goods or services that it sells to its clients, those services would not be technical services, according to the meaning explained in article 12A.

47. The definition of fees for technical services involves difficult distinctions between technical services and other services, causing inevitable uncertainty. The commentary on article 12A contains an alternative provision for developing countries that wish to avoid this uncertainty. Under the alternative provision, the contracting State in which payment for any services, other than the fees for services excluded under article 12A, arises is entitled to impose withholding tax on the gross amount of the payment to a resident of the other contracting State, but only if the services are performed in the first State or are paid to a closely related person in the other State. Thus, under the alternative provision, a developing country can tax all payments for services — technical and other services — performed in the country, but it can tax payments for services performed outside the country only if the services are provided by a resident of the other country that is closely related to the payer for the services. The alternative provision may be attractive to developing countries because it avoids the uncertainty involved in distinguishing between technical and other services and targets intragroup services that pose the greatest risk of base erosion.

Tax administration issues

48. In general, non-resident service providers may be taxable on their net income in the same manner as residents or on the gross payments that they receive for their services without any deductions. If non-residents are subject to tax on their net income from services, they are usually required to file tax returns showing their income subject to tax and the tax payable. Although the payments for services that they derive may be subject to withholding, such withholding is provisional; it represents payments owed because of the non-resident's tax payable as finally established by the assessment of the non-resident's tax return. If non-resident service providers are subject to withholding taxes on the gross payments they receive from their clients, the tax withheld is usually the final tax. The non-resident is not allowed to pay tax on a net basis, although in some circumstances a non-resident may be allowed to file a tax return and claim a refund for excessive tax withheld.

49. If non-resident service providers are taxable by assessment, the tax authorities face the difficult task of identifying non-resident service providers that are required to file tax returns. This difficulty can be minimized if non-resident service providers are subject to interim or final withholding. To the extent that non-resident service providers are subject to withholding, the obligation to identify non-residents subject to tax and the amount of the tax is effectively shifted to the withholding agents.

50. In order to administer the provisions of domestic law and tax treaties effectively, the tax authorities must have the power to gather the necessary information from the taxpayer and other entities, such as financial institutions and withholding agents, and to audit the provisions of domestic law and verify that they have been complied with. Therefore, developing countries should consider whether the disclosure and information-reporting requirements under domestic law and the resources devoted to audit and verification activities are adequate for this purpose.

51. The tax authorities of developing countries also need to apply the provisions of their tax treaties with respect to the taxation of income from services. In this regard, the application of tax treaties involves the determination of:

(a) The residence of a non-resident service provider — often, certificates of residence from the foreign tax authorities are required for this purpose;

(b) The applicable article of the treaty;

(c) Whether the non-resident service provider qualifies for the benefits of the particular article of the treaty;

(d) The profits attributable to a permanent establishment or fixed base, in accordance with the provisions of article 7 or 14 of the United Nations Model Convention;

(e) Whether the payments to associated non-residents for services conform to arm's length amounts;

(f) Whether the proper amount of withholding tax has been withheld in accordance with the relevant article of the treaty, and whether any excess amount must be refunded.

Checklist of the major risks of base erosion and possible countermeasures

Risks	*Countermeasures*
Income from employment	
• Non-resident employees working for a permanent establishment or fixed base of a non-resident inside a country	• Impose withholding obligation on employer and deny deduction if no withholding
• Non-resident employees working for a permanent establishment or fixed base of a non-resident outside a country	• Impose withholding obligation on employer and deny deduction if no withholding; ensure that tax treaties do not prevent collection of domestic tax
• Non-resident employees who are, in substance, employees of a resident employer, but legally employed by a non-resident employer (international hiring out of labour)	• Apply special provision in tax treaties, or domestic or treaty anti-abuse rule
• Non-residents who are, in substance, employees of a resident employer, but are legally independent contractors	• Determine employment relationship on the basis of economic substance • Apply domestic or treaty anti-abuse rule
• Remuneration of non-resident directors and top-level managers	• Ensure that amounts are taxable under domestic law and that resident companies have an obligation to withhold; include article 16 in tax treaties
Income from entertainment and sports activities	
• Short-term entertainment and sports activities of non-residents in a country where non-residents earn substantial amounts	• Tax all income from entertainment and sports activities of non-residents in the country; include article 17 in tax treaties
• Income from entertainment and sports activities is assigned to another person	• Ensure that domestic law contains anti-avoidance rules and that treaties include article 17 (2)
Business, professional and other independent services	
• Non-residents performing substantial services in a country without having a permanent establishment or fixed base in the country, in particular where non-residents artificially avoid having a permanent establishment or fixed base	• Ensure that domestic law and/or tax treaties contain anti-avoidance rules • Negotiate a shorter time period for construction and services-related permanent establishments
• Non-residents performing substantial services outside a country for clients who are resident or carrying out business in the country, in particular where those clients claim deductions for payments to the non-resident service providers	• Ensure that payments for services are taxable under domestic law and impose the obligation to withhold on payers with the denial of deductions if they fail to withhold; also ensure that tax treaties do not prevent domestic taxation

Risks	*Countermeasures*
• Substantial income earned by non-resident insurance companies without a permanent establishment in a country	• Ensure that insurance companies are taxable on income from insuring risks or collecting premiums without the need for a permanent establishment and include article 5 (6) in tax treaties
• Payments by residents for services provided by related non-residents where the amount of the payments is greater or less than the arm's length amount	• Apply transfer pricing rules effectively
• Non-residents performing services, such as technical services, outside a country for clients who are resident or carrying out business in the country, in particular where those clients claim deductions for the payments to the non-resident service providers	• Impose withholding tax on such payments irrespective of where the services are performed and include article 12A of the United Nations Model Convention in tax treaties